

**STATE OF WASHINGTON  
OFFICE OF THE INSURANCE  
COMMISSIONER**



**FINANCIAL EXAMINATION  
OF  
PEMCO INSURANCE COMPANY  
SEATTLE, WASHINGTON**

**NAIC CODE #18805  
DECEMBER 31, 2003**

Participating States:  
Washington

## CHIEF EXAMINER'S AFFIDAVIT

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SALUTATION

Seattle, Washington  
May 17, 2005

The Honorable Alfred W. Gross  
Chair, NAIC Financial Condition (E) Committee  
State Corporation Commission  
Bureau of Insurance  
Commonwealth of Virginia  
PO Box 1157  
Richmond, VA 23218

The Honorable Linda Hall, Director  
Alaska Division of Insurance  
Secretary, Western Zone  
550 West 7<sup>th</sup> Avenue, Suite 1560  
Anchorage, AK 99501-3567

The Honorable Mike Kreidler, Commissioner  
Washington State Office of the Insurance Commissioner (OIC)  
Insurance 5000 Building  
5000 Capital Blvd.  
Tumwater, WA 98504-0255

Dear Commissioners and Director:

In accordance with your instructions and in compliance with the statutory requirements of RCW 48.03.010, an examination was made of the corporate affairs and financial records of

PEMCO INSURANCE COMPANY  
of  
Seattle, Washington

hereinafter referred to as "PIC" or the "Company", at its home office located at 325 Eastlake Avenue East, Seattle, Washington 98109-5466. The following report on the examination is respectfully submitted showing the condition of the Company as of December 31, 2003.

## **SCOPE OF EXAMINATION**

This examination covered the period January 1, 1999 through December 31, 2003 and comprised a comprehensive review of the books and records of the Company. The examination followed the statutory requirements contained in the Washington Administration Code (WAC), the Revised Code of Washington (RCW), and the guidelines recommended by the National Association of Insurance Commissioners (NAIC) Financial Condition Examiners Handbook (FCEH). The examination included identification and disposition of any material transactions and events occurring subsequent to the date of examination that were noted during the examination. The findings of the previous examination report were reviewed and all items were satisfactorily addressed.

Corporate records, external reference materials, and various aspects of the Company's operating procedures and financial records were reviewed and tested during the course of this examination and are commented upon in the following sections of this report. In addition, the Company's certified public accountant's (CPA's) work papers were reviewed and utilized, where possible, to facilitate efficiency in the examination.

## **INSTRUCTIONS**

The examiners reviewed the Company's filed 2003 NAIC Annual Statement as part of the statutory examination. This review was performed to determine if the Company completed the NAIC Annual Statement in accordance with the Annual Statement Instructions published by the NAIC and to determine if the Company's accounts and records were prepared and maintained in accordance with Title 48 RCW, Title 284 WAC, and the NAIC's Statements of Statutory Accounting Principles (SSAP) as contained in the NAIC's Accounting Practices and Procedures Manual (AP&P).

The following summarizes the exceptions noted while performing this review.

### **1. Conflict of Interest**

PIC's Conflict of Interest Policy requires that conflict of interest disclosures be updated every three years. For the examination period, there was only one disclosure form each for one officer and one director, although the other officers and directors complied with the policy.

**RCW 48.05.370 states, "Officers and directors of an insurer... shall be deemed to stand in a fiduciary relation to the insurer, and shall discharge the duties of their respective positions in good faith, and with that diligence, care and skill which ordinary prudent men would exercise under similar circumstances in like positions." In order to monitor compliance with this statute, the Company is instructed to obtain and review conflict of interest declarations from appropriate**

**personnel and to report the results to the Company's Board of Directors, as required by the Conflict of Interest Policy.**

## **2. Custodial Agreement**

In the 2003 NAIC Annual Statement Interrogatory #22.01, the Company stated that its Custodial Agreement with US Bancorp complied with the NAIC Financial Condition Examiner's Handbook. However, the Company's agreement contained the following deficiencies:

- The Agreement does not allow PIC's securities that are not held subject to deposit requirements to be withdrawable upon demand.
- For the loss of securities which US Bank is obligated to indemnify PIC, the Agreement does not clearly require US Bank to promptly replace the securities or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities.
- The Agreement does not require US Bank to allow an officer or employee of PIC, an independent accountant selected by PIC, and a representative from the OIC to be entitled to examine US Bank's records relating to the securities on the premises of US Bank during regular business hours.
- To the extent that certain information maintained by US Bank is relied upon by PIC in preparation of its annual statement and supporting schedules, the Agreement does not require US Bank to maintain records sufficient to determine and verify such information.
- The Agreement does not require insurance by the custodian.

**The Company is required to follow the NAIC's Annual Statement requirements as noted in WAC 284-07-050(2). Adherence to the FCEH is one of these requirements. The Company is instructed to correct all deficiencies noted above and execute a revised or amended custodial agreement.**

## **3. Internal Audit Department**

During the period covered by our examination, the internal audit department performed 16 audits. This coverage should be evaluated by comparing it to an objective prioritization of significant, sensitive control areas and cycles. If it is found to inadequately cover the required areas in either scope or frequency, consideration must be given to strengthening the department or refocusing its mission. Currently, the department consists of three professionals and the organization charts shows that its resources are diverted to other tasks such as contract administration. This situation is of particular concern, since the Company has no Audit Committee to monitor the department's scope, coverage or results.

**The Company is instructed to comply with RCW 48.05.370, which states that officers and directors "...shall discharge the duties of their respective positions in**

good faith, and with that diligence, care and skill which ordinary prudent men would exercise under similar circumstances in like positions". This should include creating an Audit Committee which would be responsible for ensuring that the Internal Audit Department adequately covers significant, sensitive control areas and avoids even the appearance of subjectivity by devoting all its resources to performing internal audits.

#### **4. Drafts versus Checks**

The Company issues negotiable instruments for claims payments and accounts for them as drafts while its bank considers them to be checks. According to SSAP #2, paragraph 6, a draft is paid only upon approval by the reporting entity. This is not the case with PIC. By reporting the claims payments as drafts versus checks, the Company records a draft liability. The entry should have been a credit to cash.

**Pursuant to RCW 48.05.073 which requires conformity with NAIC accounting practices, RCW 48.05.250 which requires a "true statement" in the NAIC form, and SSAP #2, paragraph 6 & 7, which defines drafts and checks, the Company is instructed to follow the NAIC Annual Statement Instructions and SSAP when preparing its annual statement and to record the claim payments as checks.**

#### **5. NAIC Annual Statement Preparation – Intercompany Taxes**

The Company reports intercompany receivables/payables arising from participation in its consolidated tax return with its parent, PEMCO Mutual Insurance Company (PMIC) as an intercompany receivable/payable on the NAIC Annual Statement instead of as a tax liability or a tax recoverable.

**The Company is instructed to comply with RCW 48.05.250 and file a true statement of its financial conditions, transactions and affairs; with RCW 48.05.073 which requires the filing of its financial statements in accordance with AP&P; and WAC 284-07-050(2) which requires adherence to the NAIC Annual Statement Instructions and AP&P.**

#### **6. Preemptive Controls Over Claims Processing and Employee Transactions**

PIC issues claims checks either electronically or in the field. The checks issued in the field are signed by the adjuster assigned to the claim. No other signatures are required. If the claim exceeds the adjuster's signing limit additional authority is given through an "override". This could be 2 to 3 times the adjuster's authority. The claim checks are issued electronically and are preprinted with the treasurer's signature. Even though the adjuster does not have access to the check, there are no controls in place to prevent the adjuster from having it sent to a PO Box.

The internal audit department uncovered instances where a claims department supervisor was involved in processing his own claim and another employee disguised a premium delinquency on his policy. There are no internal procedures barring employees from processing claims or accounts receivable where they have an interest in the claim or policy. At a minimum, there should be procedures to prohibit such capabilities and to actively search for such relationships using automated search facilities.

**The above instances of deficient controls and procedures demonstrate lapses in fiduciary responsibility. Pursuant to RCW 48.05.370, which states that "Officers and Directors of an insurer... shall be deemed to stand in a fiduciary relation to the insurer, and shall discharge the duties of their respective positions in good faith, and with that diligence, care and skill which ordinary prudent men would exercise under similar circumstances in like positions," the Company is instructed to develop preventive controls in its claim processing and to establish procedures to prohibit employees from processing claims or accounts receivable in which they have an interest.**

### **COMMENTS AND RECOMMENDATIONS**

#### **1. Cash Control**

Unidentified receipts are stored in a safe in the Accounts Receivable Department rather than being deposited into a PIC bank account and placed under accounting control. If the receipts cannot be identified after 30 days, they are mailed back to the issuer.

**It is recommended that the Company immediately enhance its control over cash by depositing unidentified receipts into a bank account.**

#### **2. Perception of Governance**

Although the PEMCO companies are not publicly held, it is advisable to configure any company's governance and internal control procedures to comply with public company requirements. Currently, the Company's president is included on most important committees and possesses approval authority for most transactions and payment facilities, although there may be cultural and even actual controls to mitigate or offset these powers. This authority is probably understood within the Company as being traditional and possibly minimal, but it could give a negative impression to an external party, especially in the absence of an audit committee.

**It is recommended that the entire subject of corporate governance, internal controls and approval powers be reviewed and adjusted, if appropriate.**



### **3. Reserving**

During our completeness testing of paid and reserved claims, we found one claim which, for more than two years, had not been properly reserved, apparently in violation of established claims reserving procedures.

**It is recommended that the Company take steps to ensure compliance with established control procedures for establishing and monitoring reserves on open claims.**

### **4. Control of Reinsurance Contracts**

PIC receives reports from its reinsurers analyzing reinsurance pricing and performance with respect to both PIC's and the reinsurers' results. Negotiation of PIC's reinsurance contract terms comes directly out of the reinsurers' analyses. The Product Department and Company actuaries coordinate this process, but no one at PIC is responsible for performing an analysis or developing a rationale for approving its reinsurance contracts.

**It is recommended that PIC analyze, develop a rationale for, and document its process for approval of its reinsurance contracts.**

### **5. Investment Custodian**

The Company does not perform a periodic review of the financial condition and capabilities of its investment custodian. It relies on its 30 year business history with the bank as support for its continuing relationship.

**It is recommended that the Company perform a periodic review of its investment custodian to ensure that it is meeting expectations.**

## **COMPANY PROFILE**

### **Company History**

The OIC's previous examination covered the period January 1, 1993 to December 31, 1998.

PIC was incorporated on May 4, 1972, as a stock multiple line property and casualty insurance company under the laws of the state of Washington. PIC is licensed to operate in the state of Washington. The Company's Certificate of Authority was issued on August 22, 1972 and authorized the business of property, vehicle, casualty, and surety insurance.

## **Territory and Plan of Operation**

PIC utilizes direct and independent agents to acquire new business. Servicing of customers is accomplished either by an independent agent or by the Company.

## **Growth of Company**

The Company's growth, as reported in its filed NAIC Annual Statements, is illustrated below.

|      | <u><b>Assets</b></u> | <u><b>Liabilities</b></u> | <u><b>Capital and Surplus</b></u> |
|------|----------------------|---------------------------|-----------------------------------|
| 1999 | \$150,562,238        | \$84,196,881              | \$66,365,357                      |
| 2000 | 153,719,301          | 83,268,777                | 70,450,526                        |
| 2001 | 158,430,195          | 87,511,996                | 70,918,199                        |
| 2002 | 158,359,963          | 91,057,269                | 67,302,693                        |
| 2003 | 161,294,515          | 98,100,752                | 63,193,763                        |

|      | <u><b>Premiums</b></u> | <u><b>Net Investment<br/>Income</b></u> | <u><b>Losses</b></u> |
|------|------------------------|---|----------------------|
| 1999 | \$69,672,935           | \$6,912,956                             | \$42,942,720         |
| 2000 | 70,382,232             | 7,186,033                               | 43,440,354           |
| 2001 | 71,266,558             | 6,807,511                               | 45,753,907           |
| 2002 | 71,894,807             | 6,342,992                               | 49,504,058           |
| 2003 | 74,361,819             | 6,204,919                               | 51,662,385           |

## **Affiliated Companies**

**PEMCO Mutual Insurance Company (PMIC)** is organized as a mutual insurer in the state of Washington. The Company is licensed to operate only in the state of Washington and writes multiple-lines property and casualty coverage for the general public. It owns 100% of PIC.

**PEMCO Corporation (CORP)** is a stock company that was incorporated in the state of Washington during 1983. CORP provides data processing services, and leases automobiles and office equipment to the three insurance companies and other companies under common management.

**PEMCO Life Insurance Company (PLIC)** is a Washington corporation organized as a stock insurance company on May 27, 1963. PLIC is authorized to write participating and non-participating insurance coverages.

**Washington State Teachers Credit Union (WSTCU)** was founded by Robert J. Handy and a group of educators in 1936. Today, the Credit Union is one of the largest members owned credit unions in the state.

**Teachers Credit Company (TCC)** was incorporated under the laws of the state of Washington during 1941. TCC retains and exercises the proxy votes of the policy holder members of PMIC.

**Evergreen Bank (EB)**, formerly Teachers State Bank, was incorporated under the laws of the state of Washington on December 28, 1970 and commenced business on October 1, 1971. EB provides banking services for all affiliated companies.

**Public Employees Insurance Agency (The Agency)** is a stock company incorporated in the state of Washington during October 1968. The Agency sells insurance and collects premium on behalf of the affiliated insurance companies.

### **Intercompany Contracts**

As of December 31, 2003, the Company was a party to the following intercompany contracts:

|                            |                 |
|----------------------------|-----------------|
| Tax Sharing Agreement      | January 1, 2001 |
| Shared Services Agreements | January 1, 2000 |
| Cost Sharing Agreements    | January 1, 2003 |

## **MANAGEMENT AND CONTROL**

### **Board of Directors (BOD)**

As of December 31, 2003, the Company was controlled by a nine-member BOD of which seven are outside directors. All BOD members are elected for a one-year term at the annual stockholders' meeting.

| <u>Name</u>        | <u>Principal Business Affiliation</u>                                 |
|--------------------|---|
| Stan W. McNaughton | President and Chief Executive Officer, PEMCO Mutual Insurance Company |
| Richard S. White   | Retired   |
| Ed K. Erickson     | Retired   |

|                    |  |
|--------------------|--|
| Carl E. Tingelstad | Retired  |
| Roger A. Reimer    | Retired  |
| Sandra M. Kurack   | President, Secretary-Treasurer and Director of School Employees Credit Union of Washington |
| Shirley L. Hodgson | Executive Director, Human Resources Marysville Public School District                      |
| Robert D. Sealey   | Retired  |
| Borge O. Saxberg   | Professor, University of Washington Business School  |

### **Officers**

The officers on December 31, 2003 were:

|                         |           |
|-------------------------|-----------|
| Stan William McNaughton | President |
| Steven Anthony Ricco    | Treasurer |
| Richard Stanley White   | Secretary |

### **Committees**

PIC's corporate bylaws provide that the BOD shall designate an Executive Committee at its first regular meeting of each year. Additionally, the BOD has the authority to appoint such additional standing or temporary committees as the Board deems necessary. Active committees during the period of the examination were the Executive Committee, the Investment Committee, a Proxy Committee, a Nominating Committee and an Executive Compensation Committee. None of these committees kept minutes that were submitted to the BOD.

### **Conflict of Interest**

All affiliated companies have a combined Conflict of Interest and Confidentiality Policy which requires completion of a conflict of interest statement by officers, directors and key employees every three years. All are required to disclose relevant outside interests, memberships, associations and affiliations to the president, chairman, or BOD of the respective company. The Company provided only one conflict of interest disclosure for an officer and one director, the other officers and directors complied with the policy.

### **Fidelity Bond and Other Insurance**

The Company has a Fidelity Institution Bond with Hartford Fire Insurance Company with a Single Loss Limit of Liability of \$5,000,000 and a Single Loss Deductible of \$25,000. This bond covers all employees of the Company.

### **Officers', Employees', and Agents' Welfare and Pension Plans**

The Company offers a 401(k) Savings and Profit Sharing Plan. This is a defined contribution plan where the employer pays eligible employees for their contributions to the continued success of the Company. Employees may contribute up to 15% of their salary to the plan, which is subject to a two-for-one Company match of the first 6%.

The Company offers a non-qualified deferred compensation plan for certain senior executives and directors of the Company.

In addition to deferred compensation benefits, the Company provides certain medical and dental insurance coverage for retired employees. Employees become eligible for these benefits by attaining age 62 with at least 15 years of service.

## **CORPORATE RECORDS**

The initial Articles of Incorporation were adopted by the Company organizers on April 26, 1972 and were filed with the state of Washington in accordance with the Washington Insurance Code. There have been no subsequent amendments to the original Articles of Incorporation.

The corporate bylaws were amended once during the examination period. On November 15, 2001, the Chairman's duties were revised.

The BOD was active during the examination period. Meetings were well attended and the minutes were in sufficient detail and substance to demonstrate that the BOD members were actively involved in the administration of the affairs of the Company. All meetings were documented in writing, noting discussion items and specific actions taken.

## **LOSS EXPERIENCE**

### **Unpaid Losses and Loss Adjustment Expenses**

The reserves carried by the Company for these liabilities were \$39,641,154 and \$8,799,232, respectively, as of December 31, 2003.

These reserves were reviewed by the casualty actuarial staff employed by the OIC. The Company provided loss and loss adjustment expense development data by accident year

and subline. Actuarial staff obtained additional information by interviewing several Company employees. They also reviewed an actuarial report prepared by PricewaterhouseCoopers, the Company's consulting actuarial firm.

The OIC actuarial staff's estimates indicate that the reserves for both losses and loss adjustment expenses, on a net basis, are within a reasonable range. Therefore, these reserves are accepted as they appear in the Company's 2003 NAIC Annual Statement.

### **REINSURANCE**

In 2004, the latest year available, the Company retained \$500,000 per property risk for non-boat owners' property, while it had retained \$225,000 in 2003. It retained \$75,000 of boat owners' property in both years. Casualty risks were retained for \$500,000 per occurrence in both years. Maximum cessions to Employers Reinsurance Corporation under these treaties were \$2,500,000 in 2004 and \$1,750,000 in 2003 for each property risk and occurrence and \$3,500,000 for casualty in both years. For umbrella risks coverage in both years, it retained 5% of the first \$1,000,000 and reinsured the remainder of a maximum \$3,000,000. Catastrophic coverage was provided by Lloyds' syndicates for 80% in 2004 and 95% in 2003 of a maximum \$155,000,000, after the Company's \$30,000,000 retention per occurrence.

All the contracts have insolvency clauses and other wording generally utilized in such agreements, and the catastrophe coverage excludes terrorism. PIC assumes no reinsurance.

### **ACCOUNTING RECORDS AND INFORMATION SYSTEMS**

The Company maintains its accounting records on a modified GAAP accrual basis of accounting and adjusts to Statutory Accounting Practices (SAP) basis for NAIC Annual Statement reporting. The Company is audited annually by the certified public accounting firm of PricewaterhouseCoopers. The Company received an unqualified opinion for all years under review. The Company's accounting procedures, internal controls, and transaction cycles were reviewed during the planning and testing phase of the examination and no exceptions were noted.

The management of the PIC is sufficiently knowledgeable of the information systems (IS) process. Systems development, acquisition, and maintenance controls were evaluated to gain assurance that appropriate controls are in place. Operations and application controls were reviewed to determine the type of hardware installed; operating systems and proprietary software in use; back up and recovery facilities employed; and the controls exercised to maintain data security. Sufficient internal controls are in place and monitored by the Company. The Company's IS Department has the ability to recover

from an incident or disaster and has documented these procedures in a detailed, written disaster recovery plan.

### **SUBSEQUENT EVENTS**

NONE

### **FOLLOW UP ON PREVIOUS EXAMINATION FINDINGS**

All previous report instructions and comments have been corrected.

### **FINANCIAL STATEMENTS**

Assets, Liabilities, Surplus and Other Funds

Summary of Operations

Reconciliation of Capital and Surplus For the Period Since the Last Examination

Analysis of Changes in Financial Statements As a Result of the Examination

**PEMCO INSURANCE COMPANY**  
**ASSETS, LIABILITIES, SURPLUS AND OTHER FUNDS**  
**DECEMBER 31, 2003**

|  | BALANCE PER<br>COMPANY      | REF | EXAM<br>ADJ       | BALANCE PER<br>EXAM         |
|--|-----------------------------|-----|-------------------|-----------------------------|
| <b><u>ASSETS</u></b>   |                             |     |                   |                             |
| Bonds  | \$108,490,201               |     | \$0               | \$108,490,201               |
| Preferred Stock  | 4,456,525                   |     |                   | \$4,456,525                 |
| Common Stock   | 13,749,930                  |     |                   | \$13,749,930                |
| Cash and short term investments  | 5,648,964                   |     |                   | \$5,648,964                 |
| Subtotal, cash and invested assets   | <u>\$132,345,620</u>        |     | <u>\$0</u>        | <u>\$132,345,620</u>        |
| Investment income due and accrued  | 1,514,484                   |     |                   | 1,514,484                   |
| Uncollected premiums and agents' balances in course of collection                        | 2,572,099                   |     |                   | 2,572,099                   |
| Deferred premiums, agents' balances and installments booked but deferred and not yet due | 20,683,554                  |     |                   | 20,683,554                  |
| Net deferred tax asset   | 3,226,812                   |     |                   | 3,226,812                   |
| Guaranty funds receivable or on deposit  | 69,659                      |     |                   | 69,659                      |
| Receivable from parent, subsidiary and affiliates  | 882,289                     |     |                   | 882,289                     |
| TOTAL ASSETS   | <u><u>\$161,294,517</u></u> |     | <u><u>\$0</u></u> | <u><u>\$161,294,517</u></u> |
| <b><u>LIABILITIES</u></b>  |                             |     |                   |                             |
| Losses   | \$39,641,154                |     | \$0               | 39,641,154                  |
| Loss adjustment expenses   | 8,799,232                   |     |                   | 8,799,232                   |
| Commissions payable  | 254,987                     |     |                   | 254,987                     |
| Other expenses   | 3,609,738                   |     |                   | 3,609,738                   |
| Taxes, licenses and fees due or accrued excluding fit                                    | 164,269                     |     |                   | 164,269                     |
| Unearned premiums  | 39,114,002                  |     |                   | 39,114,002                  |
| Ceded reinsurance premiums payable   | 19,085                      |     |                   | 19,085                      |
| Drafts outstanding   | 3,724,021                   |     |                   | 3,724,021                   |
| Payable to parent, subsidiary and affiliates   | 2,611,271                   |     |                   | 2,611,271                   |
| Aggregare write-ins for liabilities  | 162,995                     |     |                   | 162,995                     |
| TOTAL LIABILITIES  | <u>\$98,100,754</u>         |     | <u>\$0</u>        | <u>\$98,100,754</u>         |
| Common Stock   | 1,000,000                   |     |                   | 1,000,000                   |
| Gross paid in and contributed surplus  | 1,000,000                   |     |                   | 1,000,000                   |
| Unassigned surplus   | 61,193,763                  |     |                   | 61,193,763                  |
| Surplus  | <u>63,193,763</u>           |     | <u>\$0</u>        | <u>63,193,763</u>           |
| Total liabilities, surplus and other funds   | <u><u>\$161,294,517</u></u> |     | <u><u>\$0</u></u> | <u><u>\$161,294,517</u></u> |



**PEMCO INSURANCE COMPANY  
SUMMARY OF OPERATIONS  
YEAR ENDED  
DECEMBER 31, 2003**

|  | BALANCE<br>PER COMPANY  | REF | EXAM<br>ADJ       | BALANCE PER<br>EXAMINATION |
|--|-------------------------|-----|-------------------|----------------------------|
| <b><u>STATEMENT OF INCOME</u></b>  |                         |     |                   |                            |
| <b>Underwriting Income</b>   |                         |     |                   |                            |
| Premiums Earned  | \$74,361,819            |     | \$0               | \$74,361,819               |
| <b>Deductions</b>  |                         |     |                   |                            |
| Losses incurred  | 51,662,385              |     |                   | \$51,662,385               |
| Loss expenses incurred   | 9,641,132               |     |                   | 9,641,132                  |
| Other underwriting expenses incurred   | 19,009,054              |     |                   | 19,009,054                 |
| Total underwriting deductions  | <u>80,312,571</u>       |     |                   | <u>80,312,571</u>          |
| Net underwriting gain or (loss)  | <u>(\$5,950,752)</u>    |     | <u>\$0</u>        | <u>(\$5,950,752)</u>       |
| <b>Investment Income</b>   |                         |     |                   |                            |
| Net investment income earned   | 6,204,919               |     | \$0               | 6,204,919                  |
| Net realized capital gains or (losses)   | <u>(150,414)</u>        |     |                   | <u>(150,414)</u>           |
| Net investment gain or (loss)  | <u>\$6,054,505</u>      |     | <u>\$0</u>        | <u>\$6,054,505</u>         |
| <b>Other Income</b>  |                         |     |                   |                            |
| Net gain or (loss) from agents' or premium balances charged off                          | 0                       |     | \$0               | 0                          |
| Finance and service charges not included in premium                                      | 110,366                 |     |                   | 110,366                    |
| Aggregate write-ins for miscellaneous income   | <u>0</u>                |     |                   | <u>0</u>                   |
| Total other income   | <u>\$110,366</u>        |     | <u>\$0</u>        | <u>\$110,366</u>           |
| Net income before dividends to policyholders and before federal income taxes             | 214,119                 |     | \$0               | 214,119                    |
| Dividends to policyholders   | <u>0</u>                |     |                   | <u>0</u>                   |
| Net income, after dividends to policyholders but before federal and foreign income taxes | 214,119                 |     |                   | 214,119                    |
| Federal and foreign income taxes incurred  | <u>(276,665)</u>        |     |                   | <u>(276,665)</u>           |
| Net income   | <u><u>\$490,784</u></u> |     | <u><u>\$0</u></u> | <u><u>\$490,784</u></u>    |

**PEMCO INSURANCE COMPANY**  
**SUMMARY OF OPERATIONS (Continued)**  
**YEAR ENDED DECEMBER 31, 2003**

|  | <u>BALANCE<br/>PER COMPANY</u> | <u>REF</u> | <u>EXAM<br/>ADJ</u> | <u>BALANCE PER<br/>EXAMINATION</u> |
|--|--------------------------------|------------|---------------------|------------------------------------|
| <b>CAPITAL AND SURPLUS ACCOUNT</b>                 |                                |            |                     |                                    |
| Capital and Surplus, December 31, Previous Year    | <u>\$67,302,693</u>            |            | \$0                 | <u>\$67,302,693</u>                |
| Net income   | 490,784                        |            |                     | 490,784                            |
| Change in net unrealized capital gains or (losses) | 1,586,410                      |            |                     | 1,586,410                          |
| Change in net deferred income tax                  | 199,449                        |            |                     | 199,449                            |
| Change in non-admitted assets and related items    | 314,427                        |            |                     | 314,427                            |
| Dividends to stockholders                          | <u>(6,700,000)</u>             |            |                     | <u>(6,700,000)</u>                 |
| Net change in capital and surplus for the year     | <u>(4,108,930)</u>             |            | <u>0</u>            | <u>(4,108,930)</u>                 |
| Capital and Surplus, December 31, 2003             | <u><u>\$63,193,763</u></u>     |            | <u><u>\$0</u></u>   | <u><u>\$63,193,763</u></u>         |

**PEMCO INSURANCE COMPANY**  
**RECONCILIATION OF CAPITAL AND SURPLUS**  
**FOR THE PERIOD SINCE THE LAST EXAMINATION**

|   | <u><b>2003</b></u>         | <u><b>2002</b></u>         | <u><b>2001</b></u>         | <u><b>2000</b></u>         | <u><b>1999</b></u>         |
|---|----------------------------|----------------------------|----------------------------|----------------------------|----------------------------|
| Capital and Surplus, December 31, Previous Year       | \$67,302,693               | \$70,918,198               | \$70,450,525               | \$66,365,357               | \$60,377,186               |
| Net income  | 490,784                    | (2,025,947)                | 1,958,744                  | 5,868,056                  | 5,867,468                  |
| Change in net unrealized capital gains (losses)       | 1,586,410                  | (3,664,085)                | (2,175,322)                | (1,496,482)                | 2,141,323                  |
| Change in net deferred income tax                     | 199,449                    | 2,394,881                  | (231,979)                  |                            |                            |
| Change in non-admitted assets and related item        | 314,427                    | (320,354)                  |                            |                            |                            |
| Cumulative effect of changes in accounting principles |                            |                            | 699,887                    |                            |                            |
| Other   |                            |                            | 216,343                    | (286,406)                  | (2,020,620)                |
| Dividends to stockholders                             | (6,700,000)                |                            |                            |                            |                            |
| Net change in capital and surplus for the year        | <u>(4,108,930)</u>         | <u>(3,615,505)</u>         | <u>467,673</u>             | <u>4,085,168</u>           | <u>5,988,171</u>           |
| Capital and surplus on December 31, 2002              | <u><u>\$63,193,763</u></u> | <u><u>\$67,302,693</u></u> | <u><u>\$70,918,198</u></u> | <u><u>\$70,450,525</u></u> | <u><u>\$66,365,357</u></u> |

## **NOTES TO FINANCIAL STATEMENTS**

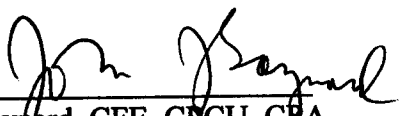
The Company has no special consents, permitted practices or orders from the state of Washington.

### **ACKNOWLEDGEMENT**

The cooperation and assistance of the officers and employees of the Company during the examination are hereby acknowledged.

In addition to the undersigned, Susan J. Campbell, CPA, FLMI, D. Lee Barclay, FCAS, MAAA, ARM; Garth Nelson; Kehinde Ovbiebo; Keith Henderson; CFE, CPA; Constantine Arustamian, CFE, CPA; Michael V. Jordan, CPA, CFE, MHP; and John Jacobson, AFE, all from the Washington State Insurance Commissioner's Office, participated in the examination and the preparation of this report.


Respectfully submitted,

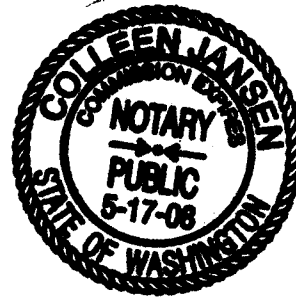


John Gaynard, CFE, CPCU, CPA

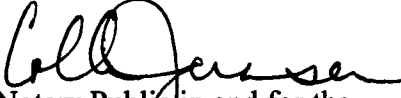
Examiner-in-Charge

Washington State Office of the Insurance Commissioner

  
John Gaynard, CFE, CPCU, CPA  
Examiner-in-Charge  
State of Washington



Subscribed and sworn to before me on this 18<sup>th</sup> day of May, 2005.

  
Notary Public in and for the  
State of Washington